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REPORT OF THE EXPERT MEETING ON PORTFOLIO INVESTMENT FLOWS AND FOREIGN DIRECT INVESTMENT

Held at the Palais des Nations, Geneva,
from 28 to 30 June 1999

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I. AGREED CONCLUSIONS [1]

1. The Expert Meeting examined how different types of investment flows could contribute to development and discussed in that regard the relationship between foreign direct investment (FDI) and foreign portfolio investment (FPI) flows. It noted the respective roles of FDI and FPI. It had a fruitful discussion helped by the contribution of prominent international experts and high-quality documentation.

A. Statistical recording

2. Improvements in recording foreign investment flows have been achieved, but the discrepancies between assets and liabilities at the global level are even larger for FPI than for FDI. Given the importance of FPI, countries should increase their efforts to ensure the accurate statistical reporting of such flows for analytical and policy-making purposes. Experts noted the importance of adhering to existing international statistical standards. They also noted the importance of improved statistical methodology to quantify FDI and FPI in order to make it compatible between different countries.

B. Contribution to development

3. Foreign investment can contribute to development by increasing resources for investment as well as by improving the policy framework (for example, bringing discipline in economic management and improving corporate governance and transparency), but developing countries should not rely on foreign investment alone for their development. FDI can bring externalities in the form of the transfer of technology and management know-how. FPI can help in increasing efficiency in domestic capital markets, by deepening these markets and raising disclosure standards. At the same time, host countries should be aware of the potentially destabilizing effects of volatile investment flows.

C. Determinants and volatility

4. Experts observed that, alongside domestic factors, portfolio investment is influenced by global liquidity fluctuations. Problems of asymmetric information and principal agency can explain the herd behaviour of investors. Portfolio investment is mainly made in bonds, which do not imply much risk-sharing, rather than in equities. Sound macroeconomic fundamentals and robust domestic financial systems are preconditions for attracting foreign investment and ensuring that it supports productive investment and a competitive economy. In general, FDI is the least volatile of investment flows, while short-term bank lending is the most volatile. The volatility of FPI lies between the two, but does not often result in net outflows. For low-income developing countries, access to both FDI and FPI is a more important concern than volatility, whereas potential volatility is more of a concern for emerging markets.

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[1] As adopted at its closing plenary meeting on 30 June 1999.

D. Policy implications

5. Experts agreed that policy measures should be taken at the national, regional and international levels, and that all such measures should be mutually supportive. Effective integration into international capital markets requires a deepening of domestic capital markets by increasing domestic savings and developing a strong domestic institutional investor base on the one hand, and by strengthening the prudential supervision of financial markets, together with sound and efficient banking systems, on the other. At the national level, it is important to avoid monetary and fiscal policies which accentuate the cyclical movements of foreign capital. Alternative policies might include open market sterilization operations, the management of reserves and other public sector assets, and market-based instruments such as taxes and reserve requirements on capital inflows. In the long term, however, controls may be less effective and in any case cannot be a substitute for sound economic management. At the regional level, increased monetary cooperation could help to reduce financial instability. For small low-income countries, it is very difficult to establish a viable capital market or to gain access to international capital markets. As a consequence, regional capital markets should be supported and multilateral financial institutions should consider support for the issuance of equities and bonds on these markets. At the international level, considerable progress has been made in setting international codes and standards for financial markets; it was suggested that developing countries should be more involved in the design of such standards. Experts considered that close coordination between national tax authorities would help to avoid harmful tax competition and reduce the resulting distortion of capital movements. Efforts should also be made to bail in the private sector in crisis management.

6. Experts expressed the hope that UNCTAD would continue to examine measures that would help developing countries, especially the least developed countries, to design adequate policies and bodies to attract stable investment flows. Furthermore, UNCTAD should support continuing expert discussions on these issues, including participants from the private sector and international and regional financial institutions.

II. CHAIRPERSON'S SUMMARY

7. The characteristics and developmental impact of foreign direct investment (FDI) and foreign portfolio investment (FPI) and the policy implications resulting therefrom were discussed in the course of the informal sessions. The main findings are incorporated in the agreed conclusions (see section I above).

A. Statistical recording

8. Although international standards for the recording of FDI have been established by the International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD), a recent survey conducted by these two institutions has shown that the "10 per cent threshold" guideline to distinguish between FDI and portfolio equity investment has not been consistently followed by all countries. Nor have all countries reported transactions between affiliated companies as FDI.

9. The borderline cases of portfolio investors who have a lasting interest while holding less than 10 per cent of the equity capital and investors who hold more than 10 per cent while having no such interest are considered as being of marginal importance. An additional criterion could be based on the investor's direct influence on the management of the firm.

10. The discrepancies between assets and liabilities of foreign investment at the global level are larger for FPI than FDI. There are still many problems related to the statistical recording of portfolio investment. As countries also hold portfolio investments as official reserves, this information is often considered as confidential and is not reported. Details of pension fund assets are also not always disclosed. Not many countries are recording financial derivatives. Financial derivatives in the future will be recorded only as financial transactions (at present, interest swaps are recorded as interest income and included in the current account). The "third-party gap" is reflected in balance-of-payments data, as these indicate only the direct parties to investment transactions, not the beneficiary parties. This problem is made worse by the large volume of transactions which are channelled through international financial centres. Furthermore, offshore centres do not report on investment transactions.

11. In order to address these problems, the IMF Committee on Balance of Payments Statistics conducted the Coordinated Portfolio Investment Survey in respect of the year-end 1997. The objectives were twofold: to collect comprehensive information on the stock of cross-border equities and long-term debt securities for use in the compilation or improvement of international investment position statistics; and to allow the bilateral exchange of comparable data, in order to improve estimates of non-resident holdings of portfolio liabilities, as well as associated capital flows and investment income data.

12. Ways to improve the recording of debt statistics are also being considered by the Inter-Agency Task Force on Finance Statistics, in order to reflect more accurately the potential drain

on reserve assets. Two problems will be tackled: debt will be recorded according to the residual maturities and long-term bonds with put options will be recorded separately.

B. Contribution to development

13. Foreign investment in general brings additional financial resources. It can also make a contribution to enhancing the policy framework, improving economic management and transparency and developing the financial infrastructure. FDI can produce a positive impact on output, employment and tax revenues, and can provide externalities in the form of the transfer of technology, management know-how and marketing networks. It has been pointed out, however, that the impact on growth is sometimes difficult to measure, as the causal relationship between FDI and growth can work in both directions, and both can be influenced by common factors such as good economic fundamentals. Some participants noted that FDI externalities could not be important if the links with local business were weak. The net effect of FDI on the balance of payments depends on the outflows resulting from remittances of earnings, fees, royalties, imports of inputs and transfer of salaries by expatriate employees.

14. FPI can bring benefits in the form of a reduction in the cost of capital to local firms, the more efficient allocation of capital for investment, a strengthening of local capital markets through additional liquidity and through "imported" supervision and regulation from the source country, and the enhancement of corporate governance through better disclosure and risk-sharing. FPI can also play an important role in financing local infrastructure. The contribution of FPI to the financing of investment is higher if made through primary markets. FPI in emerging markets has been made mainly in bonds, which do not imply risk-sharing, rather than in equity. Large fluctuations in FPI flows can have a negative impact on the balance of payments and can induce exchange rate instability, as well as high volatility of asset prices. The long-term impact on development depends upon whether FPI flows finance a higher level of fixed capital formation that is sustainable. In the short term, FPI in the form of government bonds and purchases of securities on the secondary markets would foster consumption through a wealth effect and a credit boom. Resulting exchange rate appreciation and abrupt compensatory movements in fiscal and monetary policies that accentuate the cyclical movements of foreign capital can entail high development costs, especially if domestic financial systems are weak and not well regulated and supervised.

15. Trends in investment flows in Africa, Asia and Latin America were commented on. In Africa, there has been a very small volume of investment flows, which have mainly gone to South Africa and Mauritius. One third of FDI was driven by privatization. Very few African countries have access to international capital markets. There are 16 African stock exchanges, with a total market capitalization of US$ 183 billion in 1998, with South Africa alone accounting for more than 90 per cent of this amount.

16. In Asia, it has been noted that FDI has contributed to an increase in exports from this region. For example, the ratio of exports to total sales of Japanese manufacturing affiliates in Asia is high. Until recently Japanese affiliates in Asia had relied on parent companies, regional

headquarters or Japanese banks for funding. This source of funding has diminished as a result of financial difficulties in Japan, and so Japanese affiliates will have to rely more on local capital markets.

17. In Latin America, the financial crisis which has recently affected emerging markets appears to be subsiding, with no long-term damage, but financial volatility will remain. Access to international capital markets has been renewed and spreads have come down, while stock markets have rebounded. Regional groupings like the Southern Common Market (MERCOSUR) may have played a role in attracting FDI. Smaller countries have also started to attract FDI.

C. Determinants and volatility

18. The factors affecting FDI flows are related to the size of markets, wage levels, political stability, macroeconomic stability and incentive systems. Proactive promotion policies can be effective in attracting FDI.

19. Factors which drive FPI flows are more complex and depend on the external environment as well as the internal economic fundamentals of host countries. The external factors include global liquidity and the macroeconomic policies of source countries, as well as international investors' strategies. There is general agreement that capital flows to developing countries are largely influenced by fluctuations in global liquidity. The changing demographic trends in OECD countries have resulted in strong growth in pension and mutual funds, which have contributed to increased liquidity in international capital markets. Some participants considered that global macroeconomic imbalances between major industrialized currency blocs were responsible for triggering the financial crisis in East Asia.

20. Investors' strategies and behaviour are behind the high speed of globalization of capital and channel the contagious effects of a crisis to other emerging markets. Problems of asymmetric information and principal agency may explain the herd behaviour of investors. Portfolio investors, who rarely have a local physical presence, may not possess accurate information on their borrowers and rely on common sources of information, which are often provided by credit-rating agencies. This increases the chance of the investment risk being incorrectly priced. The principal agency problem is reflected in the fact that portfolio investors, unlike transnational corporations involved in FDI, very often do not exercise direct control over the assets they acquire. These problems might explain why portfolio investors are prepared to sell their assets at the first sign of difficulties. In addition, margin calls and leveraged trading put pressure on investors to unwind their positions in risky markets in times of crisis.

21. There is general agreement that bank lending is the most volatile type of capital flow, followed by FPI and FDI. While portfolio investors can disinvest by selling securities, emerging capital markets are often not liquid enough to absorb these sales. For this reason, the scale of net portfolio outflows during the recent crisis was not that high, contrary to general assumptions. FDI as a financial flow can also be volatile, as investors hedge their exchange rate risks by matching their assets with liabilities in different currencies through bank loans and portfolio investment.

Thus although the physical assets remain in the country, transnational corporations can move out their financial investment, and sometimes do so, more easily than portfolio investors.

22. The steep declines in asset prices in emerging markets during the crisis reflect the fact that these markets are not liquid and do not act as shock absorbers. Moreover, as these markets are not deep enough to allow widespread sterilization of capital flows, these inflows have been monetized. Given the large amount of global liquidity and the small size of emerging capital markets, fluctuations in capital flows tend to destabilize borrowers' liquidity disproportionately. For these reasons, it is necessary that capital markets in emerging markets and developing countries should be developed in order to mobilize domestic savings, and also to allow more absorption of external shocks and to reduce panic selling. It was also suggested that corporations from emerging markets could raise capital on international markets and repatriate their capital only when needed.

D. Policy implications

23. As the macroeconomic impact of capital flows, and FPI in particular, can be at times destabilizing for the recipient economies, policy measures should be recommended to counterbalance any potential negative effect. At the country level, there is a set of institutional and legal arrangements which would assure the stability of the domestic financial system: under these arrangements, the central bank supplies liquidity and acts as a lender of last resort; a central body or commission is established to implement prudential regulations and supervision of financial service firms; many investors are able to act as leading market-makers; and a sound and transparent legal system governing financial transactions is put in place. At the international level, these institutional and legal arrangements are not replicated, although efforts have been made to establish and enforce international codes and standards for financial markets. However, developing countries have not always been involved in the definition of these standards. It was agreed that private creditors should be bailed in to share the burden of finding solutions to financial crises. The inclusion of a collective representation clause in bonds issued both by developed and developing countries should be encouraged.

24. There needs to be a deepening of domestic capital markets, within an appropriate regulatory and supervisory framework and with the development of a strong domestic institutional investor base. In addition, in the short term, emerging market countries might prefer to apply measures to control short-term capital rather than to have a system of freely floating exchange rates. In this respect, price-based measures, such as taxes at varying rates according to the maturity of investment, would be more effective in lengthening the maturity than quantity-based or regulatory measures, which could be circumvented by investors. Price-based measures do not erect administrative barriers to the free flows of capital. However, these controls should not be substitutes for the necessary long-term structural reforms of the financial system. To reinforce the effectiveness of these measures, an active monetary policy (in the form of open-market operations or reserve requirements to sterilize capital inflows) may be necessary. The international coordination of taxes, particularly of withholding taxes on portfolio assets, would strengthen tax-based measures by reducing tax evasion and avoiding costly tax competition.

25. Participants noted the emergence at the regional level of three major currency blocks. It was also noted that crises tended to spread quickly on a regional scale and therefore contagion could be contained by stronger regional monetary cooperation. Some participants suggested the creation of regional currency zones and monetary unions, like the European Monetary Union, but this would require true economic convergence, which could be achieved only in the very long term.

26. It was pointed out that the main concern of low-income countries was their lack of access to global capital. To address this problem, consideration should be given to the creation of regional stock markets and to encouraging multilateral financial institutions to act as intermediaries in order to enhance these countries' access to capital markets.

27. Finally, there was a brief discussion on whether or not FPI should be included in investment agreements. The question arose as to whether the use of control measures on FPI would be contradictory to the national treatment provision in investment agreements. Some participants pointed out that investment agreements could provide safeguards which would allow such controls. Other participants argued that if protection was extended to FPI, it would encourage more equity investment. It was also said that a distinction should be made between the liberalization of trade in financial services, which is regulated by the World Trade Organization, and the liberalization of trade in financial instruments which concern the IMF; the question is whether the two issues go together or can be separated.

III. ORGANIZATIONAL MATTERS

A. Convening of the Expert Meeting

28. In accordance with the recommendation made by the Commission on Investment, Technology and Related Financial Issues at the closing meeting of its third session, on 18 September 1999,[2] the Expert Meeting on Portfolio Investment Flows and Foreign Direct Investment was held at the Palais des Nations, Geneva, from 28 to 30 June 1999. The meeting was opened on 28 June 1999 by Ms. Anh-Nga Tran-Nguyen, Officer-in-Charge, Development Finance Branch, Division on Globalization and Development Strategies, UNCTAD.

B. Election of officers

(Agenda item 1)

29. At its opening meeting, the Expert Meeting elected the following officers to serve on its Bureau:

Chairperson:	Mr. Franz Nauschnigg	(Austria)
Vice-Chairperson-cum-Rapporteur:	Mr. Bambang S. Wahyudi	(Indonesia)

C. Adoption of the agenda

(Agenda item 2)

30. At the same meeting, the Expert Meeting adopted the provisional agenda circulated in TD/B/COM.2/EM.6/1. Accordingly, the agenda for the Meeting was as follows:

1. Election of officers
2. Adoption of the agenda
3. Foreign portfolio investment and foreign direct investment: characteristics, similarities, complementarities and differences, policy implications and development impact
4. Adoption of the outcome of the Meeting

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[2] See Report of the Commission on Investment, Technology and Related Financial Issues on its third session (TD/B/45/9-TD/B/COM.2/15), para. 78 and annex I.

D. Documentation

31. For its consideration of the substantive agenda item (item 3), the Expert Meeting had before it a note by the UNCTAD secretariat entitled "Foreign portfolio investment and foreign direct investment: characteristics, similarities, complementarities and differences, policy implications and development impact" (TD/B/COM.2/EM.6/2).

E. Adoption of the report

(Agenda item 4)

32. At its closing meeting, on 30 June 1999, the Expert Meeting adopted the agreed conclusions reproduced in section I above, and authorized the Chairperson to prepare a summary of the Meeting (see section II above).

Annex

ATTENDANCE *

1. Experts from the following States members of UNCTAD attended the Meeting:

Argentina
Austria
Belarus
Benin
Bolivia
Brazil
Bulgaria
Burkina Faso
Cameroon
Canada
Chile
China
Colombia
Costa Rica
Cuba
Czech Republic
Democratic People's Republic of Korea
Egypt
El Salvador
Ethiopia
France
Gambia
Germany
Guatemala
Honduras
Hungary
India
Indonesia
Iran (Islamic Republic of)
Israel
Italy
Japan
Jordan
Lebanon
Libyan Arab Jamahiriya
Madagascar
Malaysia
Mauritius
Mexico
Mongolia
Morocco
Nepal
Netherlands
Nicaragua
Norway
Pakistan
Peru
Philippines
Poland
Portugal
Republic of Korea
Romania
Russian Federation
Rwanda
Saudi Arabia
Spain
Sudan
Sweden
Switzerland
Thailand
Tunisia
Turkey
United Kingdom of Great Britain and Northern Ireland
Viet Nam
Zambia
Zimbabwe

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* For the list of participants, see TD/COM.2/EM.6/INF.1.

2. The following intergovernmental organizations were represented at the Meeting:

European Free Trade Association
Inter-American Development Bank
European Community

3. The following specialized agency and related organization were represented at the Meeting:

World Bank
World Trade Organization

4. The United Nations Environment Programme was represented at the Meeting.

5. The following non-governmental organizations were represented at the Meeting:

General Category

World Federation of United Nations Associations
Third World Network

6. The following panellists took part in the Meeting:

Mr. Arnab Banerji, Foreign and Colonial Management Ltd, London, United Kingdom
Mr. Edmund Fitzgerald, Reader in International Economics and Finance, Oxford University, United Kingdom
Mr. Michael Howell, Cross-Border Capital, London, United Kingdom
Mr. Sam Mensah, African Capital Market Forum, Accra, Ghana
Mr. John Motala, International Monetary Fund
Mr. Yung Chul Park, Professor of Economics, Korea University, Republic of Korea
Mr. Shigeki Tejima, Professor of International Economics, Nishogakusya University, Japan
Mr. Antonio Vives, Inter-American Development Bank

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Item 3 of the provisional agenda

TRENDS IN FDI AND WAYS AND MEANS OF ENHANCING FDI FLOWS TO AND AMONG DEVELOPING COUNTRIES, IN PARTICULAR LDCs AND COUNTRIES RECEIVING RELATIVELY LOW FDI INFLOWS, WITH A VIEW TO INCREASING THE BENEFITS THEY ENTAIL, AND TAKING INTO ACCOUNT THE FACTORS WHICH PLAY A PART IN PRIVATE SECTOR FIRMS' CHOICES OF INVESTMENT LOCATIONS

Report by the UNCTAD secretariat

Executive summary

This report contains a brief overview of recent trends in foreign direct investment (FDI) flows, with particular emphasis on least developed countries (LDCs), an overview of the differences and complementarities between FDI and foreign portfolio investment (FPI) flows, and a brief analysis of the determinants of FDI. It reports that besides the slowdown in world economic growth and the financial crisis in many developing countries and in the Russian Federation, global FDI inflows increased by 39 per cent, over 1997, to $644 billion. This growth was fueled by a 70 per cent increase in flows to developed countries (amounting to $460 billion) that was based on a surge in mergers and acquisitions. This increase more than offset the decline of 4 per cent in flows to developing countries in 1998, with Asia and Latin America accounting for the majority of receipts (with $85 billion and $72 billion, respectively) and Africa receiving only some $8 billion. Total 1998 FDI inflows into LDCs as a group increased by 13.5 per cent, totaling $2.4 billion. Central and Eastern Europe received $18 billion.

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Executive summary (continued)

Over the period 1991-1998, FDI and FPI represented about 90 per cent (respectively, 51 per cent and 39 per cent) of total capital flows to developing countries and countries in transition, with countries in Latin America, the Middle East, Europe and economies in transition relying mostly on FPI as a source of capital flows, Asia on FDI and Africa on official flows. Other differences and complementarities between FDI and FPI relate to their determinants and their different developmental impacts, particularly those arising from the greater volatility of FPI flows.

Three factors can be identified to explain the differences in FDI performance among countries;they play a part in the choice of firms as regards foreign investment locations and determine where they invest abroad. They are: the policies of host countries (including the core regulatory framework for FDI), the proactive measures that countries adopt to promote and facilitate investment, and the characteristics of their economies. All three factors are undergoing changes brought about by the process of globalization.

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Box 2. The joint UNCTAD-ICC project on investment guides and capacity-building for the least developed countries

Annex figures

Figure 1. World inflows of foreign direct investment by groups of countries, 1985-1998

Figure 2. Cross-border merger-and-acquisition transactions with values over $3 billion, 1996-1998

Figure 3. South, East and South-East Asia: cross-border mergers and acquisitions in relation to inflows of foreign direct investment, 1991-1998

Figure 4. Inflows of foreign direct investment into Latin America and the Caribbean, 1990-1998

Figure 5. Inflows of foreign direct investment into Central and Eastern Europe, 1993-1998

Annex tables

Table 1. Capital flows: average and coefficient of variation, 1990-1998

Table 2. Host country determinants of foreign direct investment

I. TRENDS IN FOREIGN INVESTMENT

A. Trends in flows of foreign direct investment and in least developed countries

1. Against the background of a slowdown in world economic growth to 2 per cent in 1998 (from 3.4 per cent in 1997) and the financial crisis that hit many developing countries and the Russian Federation in 1997-1998, foreign direct investment (FDI) inflows increased by 39 per cent, over 1997, to a record $644 billion (annex figure 1). This growth was fueled by a 70 per cent increase in flows to developed countries that was based on a surge in mergers and acquisitions. This increase more than offset the decline of 4 per cent in flows to developing countries. Cross-border mega deals (defined as involving transaction values of over $3 billion) were the defining characteristic of the past year, with their number doubling compared to the previous year (annex figure 2). Nearly 90 per cent of majority-owned cross-border mergers and acquisitions (M&As) were concluded in developed countries, where this mode of entry is far more important than in developing countries.

2. Inflows of FDI into developed countries jumped to $ 460.4 million in 1998, an increase of 70 per cent over the previous year. The European Union strengthened its position as the largest investor as well as largest recipient of FDI flows; however, the prospect of launching the single currency in January 1999 seemed to have had only limited impact on FDI flows, according to available data. The United States remained the single largest host and home country for FDI, with inflows reaching $193 billion and outflows $133 billion. Inflows nearly doubled their 1997 level, due mainly to large-scale M&As. Inflows into Japan reached $3.2 billion and thus remained at almost the same level as in 1997. Compared to earlier years, however, M&As appear to be playing an increasingly important role. At the same time, FDI outflows from Japan declined in 1998 by 7 per cent (reaching $24 billion), influenced by depressed domestic demand and lower profitability in the wake of economic recession.

3. In contrast, total inflows into developing countries declined by 4 per cent to $166 billion, due largely to lower flows to South, East and South-East Asia (annex figure 1). FDI inflows into Asia as a whole managed to weather the storm: although inflows declined by 11 per cent over 1997, total inflows at $85 billion remained higher, in 1998, than immediately before the crisis. On the other hand, inflows into Latin America and the Caribbean reached a new record high, amounting to $72 billion. FDI inflows into Africa as a whole continued to grow at a relatively slow pace, with inflows of $8 billion in 1998; the performance of individual countries, however, was quite diverse. Total FDI inflows into LDCs as a group increased, in 1998, by 19 per cent over the previous year, totaling $2.9 billion. FDI inflows were on the rise in almost all countries of Central and Eastern Europe (at $18 billion in 1998), with the exception of the Russian Federation, where FDI was affected by that country's economic downturn and drying up of privatization-related inflows.

4. Total inflows into Africa in 1998 amounted to $8.3 billion -- a decrease compared to the record level achieved in 1997 ($9.4 billion) -- and $7.9 billion excluding South Africa (up

from $7.7 billion in 1997)[1]. At the same time, the growth of inflows into Africa as a group continues to lag behind the dynamics of inflows into other developing regions, with the continent accounting for only 5 per cent of total FDI inflows to developing countries. However, FDI inflows into Africa as a whole remain considerably higher than the average flows recorded in the first part of the 1990s. In addition, the performance of individual countries is quite diverse: international investors are beginning to realize profitable business opportunities which many countries of the continent offer. The largest recipients of FDI inflows in Africa in 1998 are -- as in previous years -- Nigeria with FDI inflows of $1.5 billion and Egypt with $1.1 billion. Both countries accounted for more than 25 per cent of total FDI inflows into Africa (including South Africa). Among the 20 most important recipients of FDI inflows in 1998 were also a number of least developed countries, including Angola, Equatorial Guinea, Ethiopia, Liberia, Madagascar, Mozambique, Uganda and Zambia, proving that this group also can become an attractive destination for FDI. Even more interesting, some of the LDCs, such as Ethiopia, Mozambique and Uganda, received a major part of their FDI inflows in manufacturing and service industries. Overall, the share of the 33 African LDCs in total FDI inflows into Africa grew from around 21 per cent in 1997 to 27 per cent in 1998.

5. Although the Asian region as a whole experienced a contraction and a downturn in overall private capital inflows, FDI managed to weather the financial crisis: while FDI flows into the region experienced a decline of 11 per cent (the first since the mid-1980s, due mainly to sharply decreasing inflows into Indonesia (box 1) and Taiwan Province of China), total inflows of $85 billion in 1998 remained higher than immediately before the crisis, and much higher than average annual inflows during the decade. While inflows into China remained at a level similar to that of 1997, the country's share in developing Asia's total FDI rose to 58 per cent in 1998. The decline in inflows from within the region (over 9 per cent) was compensated by an increase in FDI from the United States (by 21 per cent) and from Europe (by 3 per cent). Transnational corporations (TNCs) continued to be very active in the region, driven mainly by further FDI liberalization and the availability of cheap assets in some countries. Some TNCs are restructuring their production networks in Asia to respond to changes in supply-and-demand patterns. The shortage of capital, combined with the recognition of the role FDI can play in restoring growth and development, is leading to an even more accommodating attitude towards FDI in almost all economies in the region, including further opening of certain industries to FDI and relaxing of rules with respect to ownership, mode of entry and financing. Although the decline of FDI approvals in 1998 and the first quarter of 1999 in a number of countries indicates a trend towards declining FDI flows in 1999 -- particularly depending on whether the level of inflows into China can be maintained -- it is expected that FDI inflows into the region will remain above the average of the decade. In the longer run, FDI growth is expected to resume again, based on the fundamental determinants of FDI decisions. Cross-border majority M&As in Asia, in 1998, increased by 28 per cent in value over 1997 to $12.5 billion, although if set into relation to FDI flows into Asia, the share remained relatively low (16 per cent, compared to 46 per cent

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[1] Due to a change in methodologies, figures for FDI inflows into Africa for recent years are much higher than those reported in the earlier reports to the Commission and in previous *World Investment Reports*.

in Latin America). Before the crisis, however, this figure was significantly lower (annex figure 3).

6. Although 1998 was marked a year of turbulence for emerging markets, FDI inflows to Latin America and the Caribbean reached $71.7 billion, up by 5 per cent from the previous year. South American countries accounted for about 70 per cent of total inflows (annex figure 4). Inflows of FDI into Brazil amounted to $28.7 billion in 1998, representing a substantial increase of 53 per cent over the previous year. This can be attributed to M&As, involving new foreign investors and established TNCs, as well as to privatizations, such as that of Telebras, which was sold partly to foreign investors. The United States' position as the largest single investor country, with outward flows of about $17 billion in 1998, started to be challenged by increasing inflows from the European Union since 1995. At the same time, inflows from Japan reached $5.6 billion, compared to $2.3 billion in the previous year. A comparison of foreign companies operating in the region reveals that in 1997, among the largest 100 TNCs (ranked by sales), the majority originated from the United States (44), closely followed by the European Union (37), as well as Switzerland (5) and Japan (3). Among EU investors, Spain accounted for about one third of total investment in the region in 1997; in particular, Spanish TNCs have acquired controlling stakes in important companies in the electricity industry in Chile, as well as in the oil and gas industry in Argentina.

7. Inflows of FDI into Central and Eastern Europe declined slightly in 1998 to $18.7 billion, down from $19.4 billion in 1997 (annex figure 5). While most countries experienced an increase in FDI flows, inflows into the Russian Federation declined drastically in 1998, reaching only $2 billion (or one third of the 1997 level), following the country's general economic downturn, and due partly to a declining share of privatization-related inflows which, in 1997, accounted for more than one third of total inflows while there were practically none in 1998. In addition, only a small portion of inward FDI was efficiency seeking, as foreign investors were attracted mainly by the Russian Federation's natural resources and domestic market size, thus limiting the country's capacity to transform its inward FDI into engines of export-led growth. European Union countries were the predominant source for inflows into Central and Eastern Europe other than the Russian Federation, followed by investors from the United States, while investment from the Russian Federation was minuscule. While FDI inflows into all countries of the region, in 1998, reached 95 per cent of their level in 1997, their performance was strikingly resilient compared with the drop in other capital inflows, except for the Russian Federation: FDI inflows into other countries of the region increased by 25 per cent, compared to 1997, at a time when portfolio and other investment inflows experienced a 40 per cent decline, in contrast, the Russian Federation experienced a similar decline in FDI inflows as in other capital inflows (65 per cent and 75 per cent, respectively).

8. While total FDI inflows into LDCs as a group, in 1998, increased by 19 per cent over the previous year, totaling $2.9 billion, the share of LDCs in inflows into developing countries remained low, at 1.7 per cent. Although this represents a slight increase over the previous year, FDI continues to be hampered by some characteristics shared by most of the LDCs, such as adverse climatic conditions, small domestic markets, export vulnerability, limited transport and communications infrastructure, insufficient domestic investment and lack of a skilled

labour force, as well as lack of information on profitable business opportunities (box 2). African countries accounted for the largest share of FDI inflows into LDCs in 1998 (75 per cent). While inflows do not follow a steady pattern and fluctuate over the years, a number of countries have experienced steadily increasing inflows and are expected to attract further FDI in the near future, thus reflecting achievements in introducing a more favourable investment environment. Typically, Western European investors have been more active in the region, compared to the United States and Japan; intraregional FDI, originating especially from South Africa, plays an increasingly important role. While the share of inflows into Asian LDCs in total LDCs inflows is growing, both in absolute and in relative terms, the share of LDCs in total FDI in Asia declined from 0.6 per cent in 1996 to 0.4 per cent in 1998, affected negatively by their heavy dependence on intraregional FDI and the effect of currency depreciations in the most affected countries. Foreign investors have shown increasing interest in the services sector and manufacturing in recent years, although the primary sector continues to be of importance for many countries, especially for resource-seeking investment. Manufacturing industries are of growing importance in light of LDCs locational advantage in low-cost labour-intensive activities. The progress of LDCs with privatization programmes allowed foreign investors to establish operations in formerly closed industries; in addition, the opening of telecommunications to allow competition in many countries has attracted foreign investment. While the primary sector continues to be of relevance, the most important industries for investment in the near future in manufacturing are textiles and food and beverages. Tourism will continue to be attractive to foreign investors, while telecommunications, as well as financial services and insurance, are expected to attract increasing FDI in the near future, according to the results of a survey among African investment promotion agencies.

B. Interlinkages between foreign direct investment and foreign portfolio investment

9. Balance of payments data on capital flows collected by the International Monetary Fund (IMF) show that over the period 1991-1998, FDI and FPI represented about 90 per cent (respectively 51 per cent and 39 per cent) of total capital flows into developing countries and countries in transition.[2] It is also interesting to note that, on a regional basis, countries in Latin America, in the Middle East and Europe and countries with economies in transition relied mostly on FPI as a source of capital flows, Asia on FDI and Africa on official flows. In Asia, for the five more advanced countries of East Asia (Indonesia, Malaysia, the Philippines, the Republic of Korea and Thailand), FPI was the most important source of capital, in contrast to the rest of Asia.

10. There seems to be a pattern whereby FPI becomes an important source of capital for higher-income countries. This observation is broadly confirmed by a country breakdown. Detailed information on capital flows over the period 1993-1997 for 29

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[2] This section is drawn from UNCTAD, "Comprehensive study of the interrelationship between foreign direct investment (FDI) and foreign portfolio investment (FPI)", UNCTAD/GDS/DFSB/5, 23 June 1999.

countries (for which a consistent set of data is available) indicates that the 10 countries[3] which attracted more FPI than FDI are in the higher-income bracket (with per capita GDP exceeding $2,500), with the exception of India and the Philippines. For eight of them, the volume of external finance raised through bonds was higher than that raised through equities. In addition, there is a high concentration of investment flows in general. Over the period 1993-1997, the 16 largest recipients of FPI had an amount of portfolio flows that is higher than the total of portfolio investment in all developing and transition countries. Furthermore, 12 countries are at the same time the biggest recipients of FDI and of FPI.[4]

11. FPI tends to be more volatile than FDI. This is confirmed by a comparison of the coefficient of variation, which is a measure of the variability, of FDI and FPI. Annex table 1 shows the coefficients of variation of capital flows and their components (FDI, FPI and other investment, which is mainly bank loans) over the period 1990-1998. For the 29 countries reported, the values of the coefficients of variation are the highest for the category "other investment" in 16 countries, they are the highest for FPI in nine countries, and for FDI in only four countries.[5] Comparing the coefficients of variation of portfolio equity securities and portfolio debt securities, it turns out that debt securities are more volatile than equity securities, in 19 out of 29 cases.

12. The salient characteristics concerning FDI and FPI, reflecting both their complementarities as well as their differences, can be identified as follows:

* Complementarities: FDI and FPI address different financing needs: FDI is owned by TNCs, while FPI is used more by domestic companies/entities. FDI is firm and sector specific, while FPI is more fungible.

* Unlike FDI, portfolio investors do not have managerial responsibilities in their investment and very often do not have a physical presence in host countries.

* Other developmental impacts: FDI can facilitate the transfer of technology and market access, while FPI can help to strengthen the process of domestic capital market development. FPI has a greater macroeconomic impact (through changes in asset prices and liquidity in the financial sector), while FDI can have a significant impact at the microeconomic level, shaping the productive structure of a host country.

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[3] These countries are Argentina, Brazil, India, Mexico, the Philippines, the Republic of Korea, the Russian Federation, South Africa, Thailand, and Uruguay. For Mexico, FDI and FPI are of equal importance.

[4] These twelve countries are Argentina, Brazil, Chile, China, Colombia, Czech Republic, Hungary, India, Indonesia, Mexico, Poland, and Thailand.

[5] Among the four countries of the last group, Kuwait and Saudi Arabia are oil-exporting countries, and during the period under consideration, went through a major political crisis (the Gulf War).

* The decision by TNCs to undertake FDI in one particular country is influenced mainly by that country's determinants, while FPI can be affected by factors external to host countries, such as financial policies in capital-exporting countries, the state of liquidity on international capital markets, and changes in the pattern of diversification of international portfolio.

* Volatility: FPI is more volatile than FDI, although hedging behaviour by TNC subsidiaries can also exacerbate balance-of-payments crisis. Foreign direct investors hedge their exchange risks by matching their assets with liabilities in different currencies through bank loans and portfolio investment. Thus, although the physical assets remain in the country, TNCs can move out their financial investment.

* Accessibility: only a handful of (the same) countries are hosts to large amounts of FDI and FPI.

II. FOREIGN DIRECT INVESTMENT DETERMINANTS AND DEVELOPMENT

13. To explain the differences in FDI performance among countries, described in the preceding section, it is necessary to understand the factors that play a part in the choice of firms as regards investment locations abroad. Three broad factors determine where TNCs invest abroad: the policies of host countries (including the core regulatory framework for FDI), the proactive measures countries adopt to promote and facilitate investment, and the characteristics of their economies (annex table 2).

A. Policy framework for foreign direct investment

14. The core enabling framework for FDI consists of rules and regulations governing entry and operations of foreign investors, standards of treatment of foreign affiliates and the functioning of markets. Complementing core FDI policies are other policies that affect foreign investors' locational decisions directly or indirectly, by influencing the effectiveness of FDI policies. These include trade policy and privatization policy. Policies designed to influence the location of FDI constitute the "inner ring" of the policy framework. Policies that affect FDI but have not been designed for that purpose constitute the "outer ring" of the policy framework. The contents of both rings differ from country to country, as well as over time.

15. Core FDI policies are important because FDI will simply not take place where it is forbidden. However, changes in FDI policies in the direction of greater openness may allow firms to establish themselves in a particular location, but they do not guarantee this. Since the mid-1980s, an overwhelming majority of countries have introduced measures to liberalize FDI frameworks. This has provided TNCs with an ever-increasing choice of locations and has made them more selective and demanding as regards other locational determinants. One outcome is a relative loss in effectiveness of FDI policies in the competition for investment: adequate core FDI policies are now simply taken for granted.

16. Another outcome is that countries are increasingly paying more attention to the inner and outer rings of the policy framework for FDI. The key issue for inner-ring policies is policy coherence, especially the joint coherence of FDI and trade policies. This is particularly important for efficiency-seeking FDI as firms integrate their foreign affiliates into international corporate networks. At the same time, the boundary line between inner- and outer-ring policies becomes more difficult to draw as the requirements of international production make higher demands on the efficacy of the policy and organizational framework within which FDI policies are implemented. Thus, macroeconomic policies (which include monetary, fiscal and exchange-rate policies) as well as a variety of macro-organizational policies become increasingly relevant. As the core FDI policies become similar across countries as part of the global trend towards investment liberalization, the outer ring of policies gains more influence. Foreign investors assess a country's investment climate not only in terms of FDI policies per se but also in terms of macroeconomic and macro-organizational policies. Among the policy measures that can have a direct effect on FDI is membership in regional integration frameworks, as these can change a key economic determinant: market size and perhaps market growth.

B. Business facilitation measures

17. It is in the context of a greater similarity of investment policies at all levels that business facilitation measures enter the picture. They include investment promotion, incentives, after-investment services, improvements in amenities and measures that reduce the "hassle costs" of doing business. While these measures are not new, they have proliferated as a means of competing for FDI as FDI policies converge towards greater openness. Furthermore, business facilitation measures have become more sophisticated, increasingly targeting individual investors, even though this involves high human capital and other costs. Among these measures, after-investment services can be singled out because of the importance of reinvested earnings in overall investment flows and because satisfied investors are the best advertisement of a country's business climate. Financial or fiscal incentives are also used to attract investors even though they typically enter only location-decision processes when other principal determinants are in place.

C. Economic determinants

18. Once an enabling FDI policy framework is in place, economic factors assert themselves as locational determinants. They fall into three clusters, corresponding to the principal motives for investing abroad: resource (or asset) seeking, market seeking and efficiency seeking.

19. Historically, the availability of natural resources has been the most important FDI determinant for countries lacking the capital, skills, know-how and infrastructure required for their extraction and sale to the rest of the world. The relative importance of this determinant has declined because the importance of the primary sector in world output has declined. In addition, large indigenous enterprises have emerged in developing countries with the capital and skills to extract and trade natural resources. Moreover, TNC participation in natural-resource extraction is taking place more through non-equity

arrangements and less through FDI. Nevertheless, for a number of countries the value of FDI in natural resources remains high.

20. National market size, in absolute terms or relative to the size and income of the population, has been another important traditional determinant, leading to market-seeking investment. Large markets can accommodate more firms and allow each of them to reap the benefits of scale and scope economies, one of the principal reasons that regional integration frameworks can lead to more FDI. High market-growth rates stimulate investment by foreign as well as domestic investors. Much of the inward FDI of the 1960s and 1970s was drawn by large national markets for manufacturing products, which were sheltered from international competition by tariff barriers and quotas. Large national markets were also important for those services whose non-tradability made FDI the only mode of delivery to consumers. Such investment, however, was initially small because FDI frameworks for services were typically restrictive, excluding foreign investors in many fields such as banking, insurance and most infrastructural services. Largely immobile low-cost labour was another traditional economic determinant of FDI location, particularly important for efficiency-seeking investment.

D. Impact of globalization

21. The forces driving globalization are also changing the ways in which TNCs pursue their objectives for investing abroad. Technology and innovation have become critical to competitiveness. Openness to trade, FDI and technology flows, combined with deregulation and privatization, have improved firms' access to markets for goods and services and to immobile factors of production and have increased competitive pressures in previously protected home markets, forcing firms to seek new markets and resources overseas. At the same time, technological advances have enhanced the ability of firms to coordinate their expanded international production networks in their quest for increased competitiveness. More and more firms are therefore developing a portfolio of locational assets to complement their own competitive strengths when they engage in FDI, as witnessed by the growing number of firms that are becoming transnational.

22. All these factors are changing the relative importance of different economic determinants of FDI location. The traditional determinants have not disappeared; rather, they are becoming relatively less important in FDI location decisions. The traditional motives for FDI have not disappeared either; they are being incorporated into different strategies pursued by firms in their transnationalization process. These have evolved from the traditional stand-alone strategies, based on largely autonomous foreign affiliates, to simple integration strategies, characterized by strong links between foreign affiliates and parent firms, especially for labour-intensive activities, as well as links between TNCs and unrelated firms via non-equity arrangements. Under simple integration strategies, unskilled labour becomes the principal locational determinant. Complementing it are other determinants, such as the reliability of the labour supply and adequate physical infrastructure for the export of final products. Costs feature prominently, but host country markets do not: it is access to international markets, privileged or otherwise, that matters.

23. Although this type of FDI is not new, it began to prosper under the conditions of globalization. Much of the investment in export-processing zones and labour-intensive industries has been in response to simple integration strategies, driven by cost-price competition and, more importantly, the removal of trade (and FDI) barriers in an increasing number of countries and technological advances that permit quick changes in product specifications in response to changes in demand. However, as labour costs declined in relation to total production costs and as FDI became more mobile in response to simple integration strategies, countries had to offer additional locational advantages over and above the availability of low-cost unskilled labour to attract FDI. Productivity and some level of skill, as well as good infrastructure facilities, gained in importance as locational determinants for this type of investment. Access to international markets also became more important. Losing such access could mean losing this type of investment. This contributed to the efforts of many developing countries seeking to gain permanent access to the markets of developed countries through trade agreements or regional integration arrangements. As services became more tradable, particularly in their labour-intensive intermediate production stages such as data entry, they too began to relocate abroad in response to simple integration strategies. The locational advantages sought by such service TNCs included computer literacy and a reliable telecommunication infrastructure. Again, this contributed to the upgrading of the locational advantages that countries could offer to TNCs pursuing simple integration strategies, in their efforts to attract the more sophisticated activities that TNCs were now locating abroad.

24. With more and more TNC intermediate products and functions becoming amenable to FDI, TNCs strategies are evolving from simple to complex integration. Complex integration strategies can involve, where profitable, splitting up the production process into specific activities or functions and carrying out each of them in the most suitable, cost-competitive location. More than ever in the past, complex integration strategies allow TNCs that pursue them to maximize the competitiveness of their corporate systems as a whole on international portfolio of location assets.

25. To attract such competitiveness-enhancing FDI, it is no longer sufficient for host countries to possess a single locational determinant. TNCs undertaking such FDI take for granted the presence of state-of-the-art FDI frameworks that provide them with the freedom to operate internationally, that are complemented by the relevant bilateral and international agreements and that are further enhanced by a range of business facilitation measures. When it comes to the economic determinants, firms that undertake competitiveness-enhancing FDI seek not only cost reduction and bigger market shares, but also access to technology and innovative capacity. These resources, as distinct from natural resources, are people made -- they are "created assets". Possessing such assets is critical for firms' competitiveness in a globalizing economy. Consequently, countries that develop such assets become more attractive to TNCs. It is precisely the rise in the importance of created assets that is the single most important shift among the economic determinants of FDI location in a liberalizing and globalizing world economy. In addition, the new configuration also includes agglomeration economies arising from the clustering of

economic activity, infrastructure facilities, access to regional markets and, finally, competitive pricing of relevant resources and facilities.

26. One implication for host countries wishing to attract TNCs undertaking competitiveness-enhancing FDI is that created assets can be developed by host countries and influenced by governments. The challenge is precisely to develop a well-calibrated and preferably unique combination of determinants of FDI location, and to seek to match those determinants with the strategies pursued by competitiveness-enhancing TNCs. It must be remembered too that created assets also enhance the competitiveness of national firms. Thus, policies aimed at strengthening innovation systems and encouraging the diffusion of technology are central because they underpin the ability to create assets. Also important are other policies that encourage the strengthening of created assets and the development of clusters based on them, as well as policies that stimulate partnering and networking among domestic and foreign firms and allow national firms to upgrade themselves in the interest of national growth and development.

E. Developmental impact

27. Developing countries are interested in improving their FDI determinants to attract FDI because they want to benefit from FDI as much as possible, that is, maximize its positive contributions to development and minimize its negative effects. Both development and TNCs' activities have been affected by the increasing importance of knowledge-intensive production, rapid technological change, shrinking economic space and the much greater openness of countries. In distinction from the past, for example, today most developing countries consider FDI an important resource for development. There is a role for government policies to play in countries that want to benefit from this resource, but instruments of government policy have changed within the new context, which has emerged as a result of these changes, not to mention government policy objectives that have to be reformulated to meet new requirements. As regards TNCs, the new context has created for them new opportunities and pressures. They have expanded rapidly, their number has increased significantly and they have changed their strategies: all this not only has altered host-country FDI determinants, but has also changed the modalities through which TNCs impact host-country economies.

28. The traditional contribution, and impact, expected from TNCs was to supplement domestic savings with foreign savings, thus increasing the supply of finance for development. Today, as access to financial markets and various types of financing has been liberalized in many developing countries, FDI inflows are compared with other types of flows as regards their developmental role. As countries' abilities to develop depend increasingly on how well they cope with the technological challenge and how they integrate with the world economy, contributions to technological development, skills and management techniques and export competitiveness of host developing countries have become much more important. At the same time, developing countries are committed to development that proceeds in a sustainable manner, conserving the environment and ensuring that resources are available to future generations. TNCs are well placed to make a contribution to development because they are key actors in these areas. Indeed, as FDI

comprises a bundle of assets, its impact can go far beyond its individual components and can extend to the restructuring of entire industries or even enhancing the competitiveness of the entire economy. At the same time, FDI may have negative impacts on developing countries, crowding out domestic investors or shifting the balance of some benefits from FDI through transfer pricing.

29. Given the increasing interest of developing countries not only in attracting FDI but also in benefiting from it, the special topic of the *World Investment Report 1999* focuses on the extent to which FDI can make a contribution in each of the core areas of economic development and how this contribution can be enhanced. It makes also an overall assessment of the impact of FDI on economic development and discusses in an integrated manner policies to maximize the positive, and minimize the negative, aspects of this impact.

Box 1. Flows of foreign direct investment into the five most seriously crisis-affected countries in Asia

The five Asian countries most affected by the crisis (Indonesia, the Republic of Korea, Malaysia, the Philippines and Thailand) experienced an overall decline in foreign direct investment (FDI) of some $2 billion, or 12 per cent, in 1998. FDI inflows into these countries, at $15.4 billion, were above the average of flows for the period 1991-1995 ($10.8 billion), and only modestly below the peaks recorded in 1996 and 1997.

Individual national performances varied greatly: inflows into the Republic of Korea showed the highest increase last year, five-fold compared to its average performance during the first half of the decade, followed by Thailand with an almost four-fold jump to $7 billion over the same period, while Malaysia experienced a decline. Indonesia, in contrast, suffered from divestment for the first time since 1974, compared to average inflows of $2.3 billion during the first half of the decade and an average $5.5 billion in 1996-1997. The distinctiveness of the Philippines was manifested by its continuing strong export performance and its relatively sound financial sector.

Indications are that FDI has been flowing into a wide range of industries in the five countries. In Thailand, the only country for which systematic data by industry are available (until September), significant FDI flows to financial institutions (which were about 10 times higher in 1997 than in 1996, and continued at a similar level in 1998) reflected significant buy-outs by foreign firms. While this industry is now the single largest recipient, accounting for nearly one fifth of total FDI inflows, the machinery and transportation equipment industry also has seen increasing FDI inflows, both in absolute and in relative terms.

When compared with foreign bank lending and foreign portfolio equity investment before and during the financial crisis, FDI flows into the five countries as a group are remarkably resilient. Among the reasons for this resilience are the following: corporate networks of integrated international production that have already existed in Asia, allowing some TNCs to compensate for declining domestic sales through increased exports spurred by devaluations; TNCs taking advantage of cheaper asset prices; in some cases, parent firms increasing investment stakes in their existing affiliates; as well as some TNCs having increased capital investment in response to the relaxation of FDI regimes that has taken place after the financial crisis.

In 1999, FDI inflows into the five countries are likely to remain within the range of those during the 1990s ($10-17 billion), although the performance of individual countries may differ: the investment climate in Indonesia may require more time to recover; in contrast, the value of approved manufacturing projects in Malaysia registered a 14 per cent increase in 1998. However, measures to deal with the severity of the impact of the crisis continue to be necessary.

Box 2. The joint UNCTAD-ICC project on investment guides and capacity-building for the least developed countries

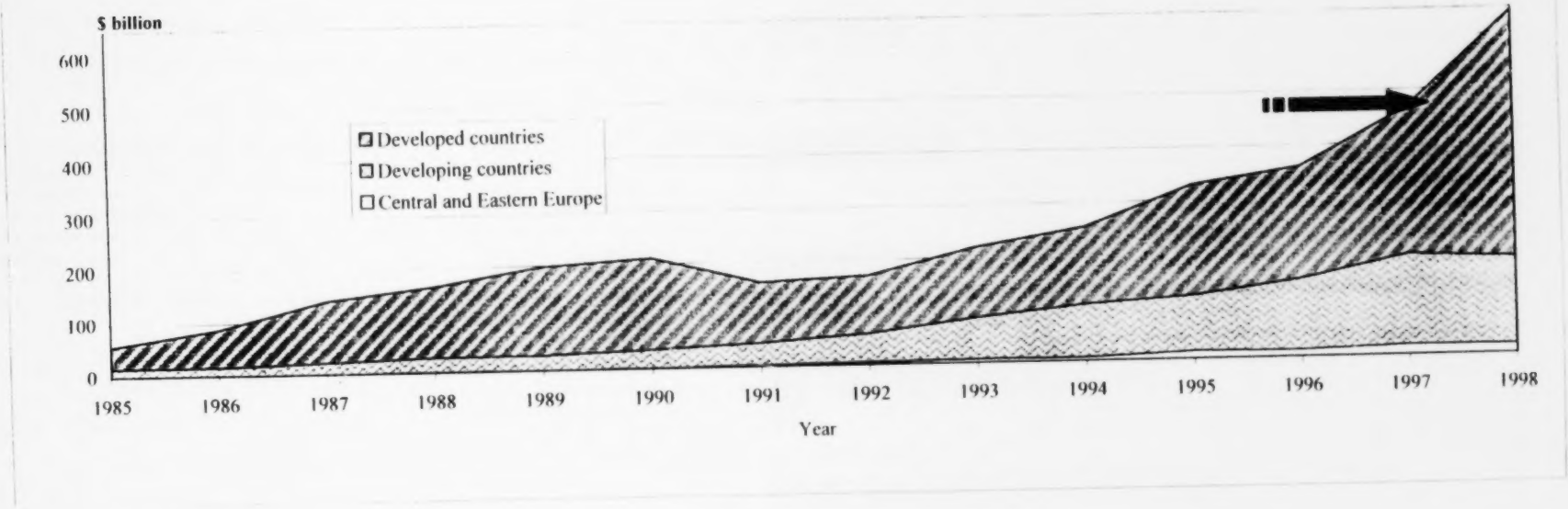
The joint UNCTAD-ICC project on investment guides and capacity-building for the least developed countries (LDCs) was launched at a meeting between the Secretary General of the United Nations, Mr. Kofi Annan, and the international business community, represented by the International Chamber of Commerce (ICC), in February 1998. The UNCTAD-ICC project is a response to the fact that LDCs are receiving less than 0.5 per cent of global foreign direct investment (FDI) flows, even though most LDCs have removed many obstacles for foreign investors and are now actively seeking FDI. The project attempts, first, to supply potential foreign investors with an objective and up-to-date overview of investment conditions in participating LDCs in the form of an investment guide. (Few proper investment guides -- as compared to promotional materials -- have been compiled for LDCs: as of June 1999, there were only three LDC investment guides (out of a total of 261) produced by the four top international accounting firms -- Arthur Anderson, Ernst & Young, KPMG and PricewaterhouseCoopers.) Secondly, the project incorporates capacity-building in LDCs in the area of investment promotion; and, thirdly, the project launches a long-term dialogue between LDC Governments and the business community.

The project was inaugurated in Ethiopia in January 1999. The workshop produced a revised and expanded draft of the guide for Ethiopia that was discussed and finalized at a second workshop in April 1999. This second workshop also offered an opportunity for discussions on the setting up of a Business Advisory Council to assist the Ethiopia Investment Authority in its efforts to create a more hospitable environment for FDI. These discussions led to the drafting of provisional terms of reference for the council and the announcement by the Ethiopian Investment Authority that it would be taking steps to set up the council.

Advanced copies of the investment guide for Ethiopia were presented at a UN-ICC meeting on 5 July 1999. The investment guide is intended to offer an overview of Ethiopia as an investment location and broadly describe the current investment climate, including the regulatory environment, where possible in a comparative framework. Work on other countries included in the pilot phase is scheduled to start this year. Work on the guide for Mali commenced in April 1999.

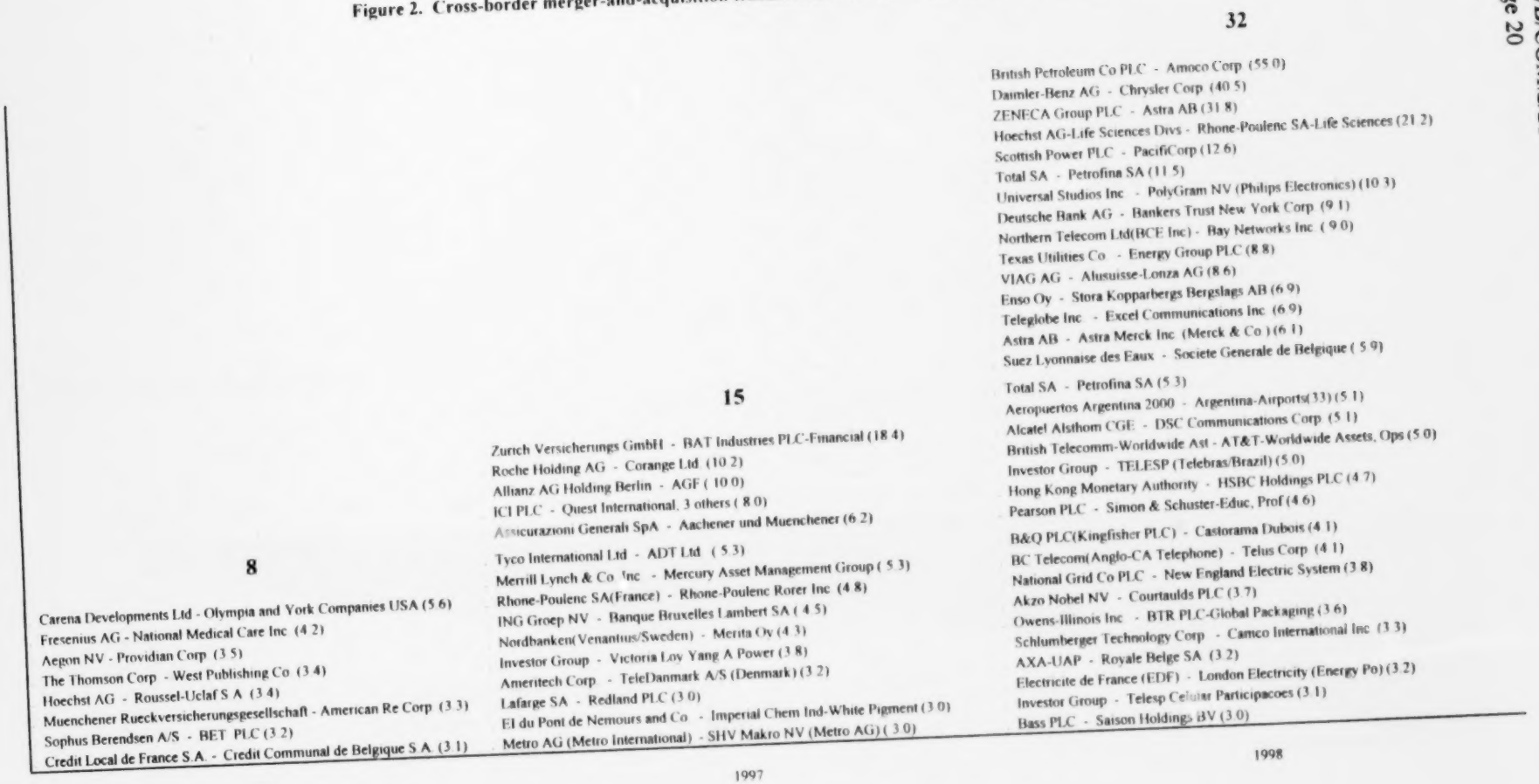
ANNEX

Figure 1. World inflows of foreign direct investment by groups of countries, 1985-1998



Source: UNCTAD, FDI/TNC database.

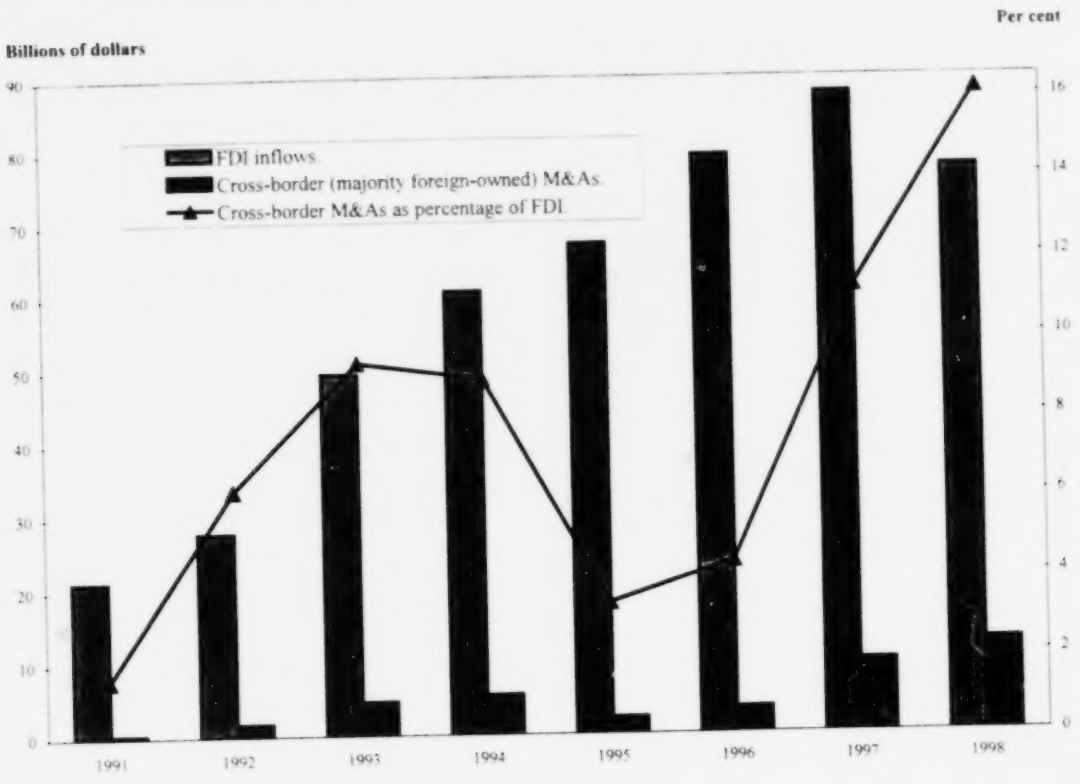
Figure 2. Cross-border merger-and-acquisition transactions with values over $3 billion, 1996-1998


8
Carena Developments Ltd - Olympia and York Companies USA (5.6)
Fresenius AG - National Medical Care Inc (4.2)
Aegon NV - Providian Corp (3.5)
The Thomson Corp - West Publishing Co (3.4)
Hoechst AG - Roussel-Uclaf S A (3.4)
Muenchener Rueckversicherungsgesellschaft - American Re Corp (3.3)
Sophus Berendsen A/S - BET PLC (3.2)
Credit Local de France S.A. - Credit Communal de Belgique S A (3.1)
1996
15
Zurich Versicherungs GmbH - BAT Industries PLC-Financial (18.4)
Roche Holding AG - Corange Ltd (10.2)
Allianz AG Holding Berlin - AGF (10.0)
ICI PLC - Quest International, 3 others (8.0)
Assicurazioni Generali SpA - Aachener und Muenchener (6.2)
Tyco International Ltd - ADT Ltd (5.3)
Merrill Lynch & Co Inc - Mercury Asset Management Group (5.3)
Rhone-Poulenc SA(France) - Rhone-Poulenc Rorer Inc (4.8)
ING Groep NV - Banque Bruxelles Lambert SA (4.5)
Nordbanken(Venantius/Sweden) - Merita Oy (4.3)
Investor Group - Victoria Lov Yang A Power (3.8)
Ameritech Corp - TeleDanmark A/S (Denmark) (3.2)
Lafarge SA - Redland PLC (3.0)
El du Pont de Nemours and Co - Imperial Chem Ind-White Pigment (3.0)
Metro AG (Metro International) - SHV Makro NV (Metro AG) (3.0)
1997
32
British Petroleum Co PLC - Amoco Corp (55.0)
Daimler-Benz AG - Chrysler Corp (40.5)
ZENECA Group PLC - Astra AB (31.8)
Hoechst AG-Life Sciences Divs - Rhone-Poulenc SA-Life Sciences (21.2)
Scottish Power PLC - PacifiCorp (12.6)
Total SA - Petrofina SA (11.5)
Universal Studios Inc - PolyGram NV (Philips Electronics) (10.3)
Deutsche Bank AG - Bankers Trust New York Corp (9.1)
Northern Telecom Ltd(BCE Inc) - Bay Networks Inc (9.0)
Texas Utilities Co - Energy Group PLC (8.8)
VIAG AG - Alusuisse-Lonza AG (8.6)
Enso Oy - Stora Kopparbergs Bergslags AB (6.9)
Teleglobe Inc - Excel Communications Inc (6.9)
Astra AB - Astra Merck Inc (Merck & Co) (6.1)
Suez Lyonnaise des Eaux - Societe Generale de Belgique (5.9)
Total SA - Petrofina SA (5.3)
Aeropuertos Argentina 2000 - Argentina-Airports(33) (5.1)
Alcatel Alsthom CGE - DSC Communications Corp (5.1)
British Telecomm-Worldwide Ast - AT&T-Worldwide Assets, Ops (5.0)
Investor Group - TELESP (Telebras/Brazil) (5.0)
Hong Kong Monetary Authority - HSBC Holdings PLC (4.7)
Pearson PLC - Simon & Schuster-Educ, Prof (4.6)
B&Q PLC(Kingfisher PLC) - Castorama Dubois (4.1)
BC Telecom(Anglo-CA Telephone) - Telus Corp (4.1)
National Grid Co PLC - New England Electric System (3.8)
Akzo Nobel NV - Courtaulds PLC (3.7)
Owens-Illinois Inc - BTR PLC-Global Packaging (3.6)
Schlumberger Technology Corp - Camco International Inc (3.3)
AXA-UAP - Royale Belge SA (3.2)
Electricite de France (EDF) - London Electricity (Energy Po) (3.2)
Investor Group - Telesp Celular Participacoes (3.1)
Bass PLC - Saison Holdings BV (3.0)
1998

Source: UNCTAD, based on data provided by Thomson Financial Securities Data Company, Inc (New York)

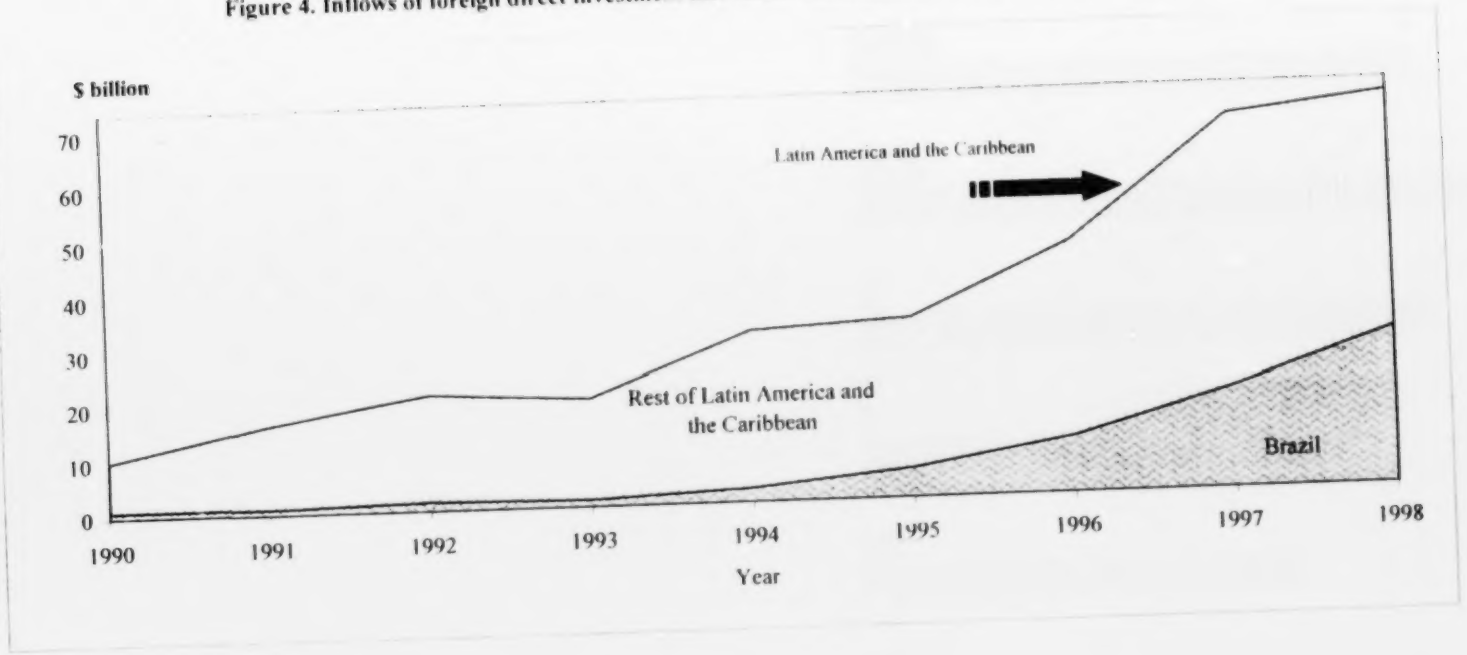
Note: Figures inside parentheses are the transaction value

Figure 3. South, East and South-East Asia: Cross-border mergers and acquisitions in relation to inflows of foreign direct investment, 1991-1998



Source: UNCTAD FDI/TNCs database, and data provided by KPMG Corporate Finance.

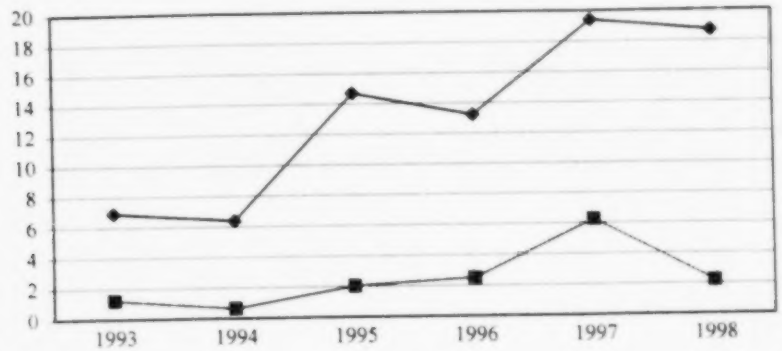
Figure 4. Inflows of foreign direct investment into Latin America and the Caribbean, 1990-1998



Source: UNCTAD, FDI/TNC database.

Figure 5. Inflows of foreign direct investment into Central and Eastern Europe, 1993-1998

(Billion dollars)



	1993	1994	1995	1996	1997	1998
Total CEE	6.908	6.378	14.69	13.212	19.408	18.695
Russian Federation	1.211	0.64	2.016	2.479	6.243	2.183

Total CEE — Russian Federation

Source: UNCTAD, FDI/TNC database.

Table 1

Capital flows: average *(millions of US dollars)* **and coefficient of variation, 1990-1998 (or latest available year)**

Country	Capital flows before changes in reserves		Direct investment		Portfolio investment		Equity securities		Debt securities		Other investment, net	
	Average	Coeff. of Variation	Average	Coeff. of variation	Average	Coeff. of variation	Average	Coeff. of variation	Average	Coeff. of variation	Average	Coeff. of variation
Egypt	963	50 1	621 4	0 5	496 5	1 8	382 1	1 9	114 4	1 8	-1214 3	-3 7
Morocco	778 6	0 8	445 4	0 6	58 2	1 5	58 2	1 5	0 0	0 0	275 0	2 9
Nigeria	-24 8	-125 4	1214 2	0 4	157 5	4 5	0 0	0 0	157 5	4 5	-1396 5	-2 4
South Africa	2332 0	1 3	-24 5	-22 7	2039 0	1 4	663 3	2 8	1902 5	0 9	317 1	2 6
Tunisia	807 8	0 4	315 7	0 6	38 8	0 9	24 9	0 7	13 8	1 4	453 1	0 5
Bangladesh	317 2	1 0	23 5	2 0	-2 8	-21 4	-2 8	-21 4	0 0	0 0	296 4	1 1
China	23310 1	0 7	22719 5	0 7	4315 0	0 8	1018 8	0 9	1276 2	1 1	-3724 4	-2 6
India	6929 8	0 4	1320 3	0 9	2177 2	0 9	2177 2	0 9	0 0	0 0	1869 1	0 6
Indonesia**	4992 7	0 9	2217 6	0 9	806 0	4 0	493 8	5 1	536 4	3 7	1969 0	1 0
Korea, Rep. of **	7719 8	1 1	971 8	0 9	7127 9	0 9	3137 9	0 7	1990 0	1 4	1561 7	4 4
Kuwait	5005 9	3 0	-168 5	-6 1	-1199 0	-1 6	0 0	0 0	-1199 0	-1 6	6373 5	2 2
Malaysia	6033 0	0 6	4803 0	0 2	-564 5	-1 0	0 0	0 0	-564 5	-1 0	2174 6	1 5
Philippines	4915 4	0 6	869 4	0 5	926 9	2 0	873 0	2 0	308 6	1 6	3119 3	0 4
Saudi Arabia	9004 0	1 2	404 1	3 7	-2144 4	-2 9	0 0	0 0	-2144 4	-2 9	10744 4	0 8
Singapore	-1555 6	-3 2	3324 0	0 4	-5263 2	-0 9	-4871 6	-1 0	-391 6	-2 5	383 9	8 5
Thailand	10832 3	0 8	1811 5	0 4	2591 0	0 8	1239 4	1 1	1351 6	1 0	6429 8	1 5
Czech Republic**	3525 6	0 7	1297 7	0 5	1103 9	0 3	603 4	0 4	500 5	0 4	1129 2	1 9
Hungary**	3098 1	1 0	2155 0	0 5	1520 8	1 2	416 5	0 8	1149 1	1 9	-665 0	1 8
Poland	2395 9	2 3	2190 0	0 9	738 0	1 6	577 7	0 4	304 8	3 3	-163 1	-24 8
Russian Fed.*	-533 0	-20 5	1882 0	0 7	13410 8	1 6	841 0	1 2	12569 8	1 7	-15825 8	-1 4
Slovenia*	362 1	1 3	166 4	0 4	136 8	1 9	51 7	0 0	128 2	2 0	58 9	5 9
Argentina	6965 6	0 8	3793 6	0 4	7426 8	1 3	324 3	1 9	7181 5	1 3	-4254 8	-1 8
Brazil	15240 4	0 8	4865 6	1 4	15493 4	1 0	1595 3	0 8	11898 1	1 2	-5118 5	-3 4
Chile**	3571 3	0 6	1711 4	0 7	602 4	1 4	368 7	1 8	233 9	1 3	1257 6	0 7
Colombia**	3036 6	0 9	1649 4	0 9	182 7	1 5	0 0	0 0	182 7	1 5	1014 5	1 5
Mexico	17925 8	0 5	7292 5	0 5	8880 5	1 4	4305 5	0 7	4575 1	2 1	1752 8	6 2
Peru	3339 9	0 5	1403 0	1 0	267 7	0 6	234 1	0 6	33 6	1 6	1767 1	0 4
Uruguay**	199 2	1 7	135 7	0 1	164 6	0 7	0 0	0 0	164 6	0 7	-56 0	-4 1
Venezuela**	-473 0	-5 4	1385 4	1 2	2084 2	2 5	445 6	1 2	1638 7	1 3	-3942 7	-1 5

Source: IMF, *Balance of Payments Statistics yearbook*, various issues, and National Sources.

* Data for Russia covers the years 1994-97 and for Slovenia the years 1992-97.

** Data covers the years 1990-98, except for the Czech Republic which is 1993-98.

Table 2. Host country determinants of foreign direct investment

Host country determinants	Tpe of FDI classified by motives of TNCs	Principal economic determinants in host countries
I. Policy framework for FDI * economic, political and social stability * rules regarding entry and operations * standards of treatment of foreign affiliates * policies on functioning and structure of markets (especially competition and M&A policies) * international agreements on FDI * privatization policy * trade policy (tariffs and non-tariff barriers) and coherence of FDI and trade policies * tax policy II. Economic determinants III. Business facilitation * investment promotion (including image-building and investment-generating activities and investment-facilitation services) * investment incentives * hassle costs (related to corruption, administrative efficiency, etc.) * social amenities (bilingual schools, quality of life, etc.) * after-investment services	A. Market seeking B. Resource/asset seeking C. Efficiency seeking	market size and per capita income • market growth • access to regional and global markets • country-specific consumer preferences • structure of markets • raw materials • low-cost unskilled labour • skilled labour • technological, innovatory and other created assets (e.g. brand names), including as embodied in individuals, firms and clusters • physical infrastructure (ports, roads, power, telecommunication) • cost of resources and assets listed under B, adjusted for productivity for labour resources • other input costs, e.g. transport and communication costs to/from and within host economy and costs of other intermediate products • membership of a regional integration agreement conducive to the establishment of regional corporate networks

Source: World Investment Report 1998: Trends and Determinants, p. 91.

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PROGRESS REPORT ON THE IMPLEMENTATION OF AGREED CONCLUSIONS AND RECOMMENDATIONS

Prepared by the UNCTAD secretariat

Executive summary

This report has been prepared in accordance with decision 446 (Ex-16) of the Trade and Development Board on "Guidelines on the efficiency and functioning of the UNCTAD intergovernmental machinery", adopted on 16 February 1998. It constitutes a progress report on "the implementation of agreed conclusions and recommendations by the secretariat" since the last session of the Commission on Investment, Technology and Related Financial Issues. As a background to this note, the secretariat has prepared a "DITE Activities Report 1998-1999" (UNCTAD/ITE/Misc.16) that provides more detailed information about the actions undertaken by the secretariat in pursuance of the mandates received at the third session of the Commission, as well as the technical assistance activities implemented by the secretariat in the areas of investment, technology and enterprise development since that session. The latter report will be made available upon request.

GE.99-52739 (E)

1. The Commission on Investment, Technology and Related Financial Issues was set up to deal with the issues mandated in paragraphs 89 (a)-(g); 91 (iii); 89 (k)-(m) and 87 (i) of "A partnership for growth and development" (TD/377). The fourth session of the Commission will be the last session before UNCTAD X, and will bring to a close the cycle of Commission sessions following Midrand.

2. At its third session, the Commission requested the secretariat to undertake a number of activities related to foreign direct investment (FDI) and foreign portfolio investment (FPI). In the area of FDI, the Commission requested the secretariat to report on trends in FDI and ways and means of enhancing FDI flows to and among developing countries, in particular LDCs and countries receiving relatively low FDI inflows, with a view to increasing the benefits they entail, and taking into account the factors which play a part in private sector firms' choices of investment locations. The document TD/B/COM.2/21 that is before the Commission has been prepared in response to this request. The Commission also requested that fact sheets on Africa and other developing country regions be prepared and disseminated; and that the materials, documents and summaries of publications prepared by the secretariat be made available on the Internet in a timely and effective manner. In response to these latter requests, the secretariat, in cooperation with the ICC, MIGA and UNDP, prepared a fact sheet based on the findings of the secretariat booklet on *Foreign Direct Investment in Africa: Performance and Potential* (UNCTAD/ITE/IIT/Misc.15). The fact sheet was launched during a press conference chaired by the Secretary-General of the United Nations, Mr. Kofi Annan, and disseminated worldwide, including on the Internet*. In addition, the secretariat has made summaries of all publications available on UNCTAD's Website.

3. The Commission also requested that study continue of the characteristics, similarities, complementarities and differences between FPI and FDI, as well as of the development impact and policy implications arising therefrom. Interest again focused on the Asian crisis and the policy challenges arising from the free flows of portfolio investment. The Commission decided to convene an expert meeting in 1999 to consider the interrelationship between FDI and FPI. This meeting took place in June 1999 and discussed: (a) the definition and statistical recording of FPI and FDI; (b) their contribution to development; (c) determinants and volatility; and (d) policy implications resulting from the differences and similarities between FDI and FPI. The agreed conclusions of the Expert Meeting reflected concerns about the choice of the right policies to maximize the contribution of foreign investment to development. The question of the treatment of FPI in international investment agreements is still an open issue.

4. In addition, the Commission requested an expert meeting on concepts allowing for flexibility in the interest of promoting growth and development, as well as the convening of meetings of the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) and of

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* Both fact sheet and booklet are available on the Internet at www.unctad.org, ww.un.org/partners/business, www.iccwbo.org, www.ipanet.net, www.kpmg.de and www.undp.org/tcdc/tcdc.htm.

the Intergovernmental Group of Experts on Competition Law and Policy. The expert meeting on concepts - such as exceptions and other mechanisms - allowing for a certain flexibility, including in the field of technological capacity-building, in the interest of promoting growth and development to allow countries at different stages of development to benefit from international investment agreements took place in Geneva on 24-26 March. It was attended by 74 member countries, with 46 represented by experts from capitals. The meeting looked at different dimensions of flexibility (e.g. clarification of the meaning and nature of the concept of flexibility; balancing flexibility and commitments; assessing the actual needs of flexibility to achieve development objectives; how to ensure that flexibility in IIAs leads to concrete results in development; optimum use of the concept) and also discussed some issues that went beyond the initial scope of the meeting (such as examining flexibility in existing IIAs, how to build it in future IIAs, and the issue of transparency). The meeting requested, in its agreed conclusions, that the background issues paper prepared by the secretariat be revised in light of the discussions and be submitted to the fourth session of the Commission under agenda item 3. The revised paper will be made available in document UNCTAD/ITE/Misc.17.

5. The sixteenth session of the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) was held from 17 to 19 February 1999. It was attended by 58 member countries (121 experts), 7 international organizations and 12 professional associations. The main agenda item was the development of a global accounting curriculum and other qualification requirements for professional accountants. The Group reviewed and adopted the guideline for the qualifications of professional accountants, including the model curriculum, and recommended them to those national authorities who are responsible for ensuring an adequate level of competence of professional accountants. The Group also examined its activities in relation to its mandate and undertook a self-assessment of its functioning. It further reviewed the study on the role of accounting in the East Asian crisis, which examined the actual accounting practices of 90 of the largest banks and corporations in six Asian countries. The study concluded that if reliable accounting information had been available, excessive financial exposure would have been detected earlier, allowing investors and creditors to take corrective measures against the conditions which led to the financial crisis. At its closing plenary session, the Group agreed to transmit the provisional agenda for its seventeenth session to the Commission. The main agenda item to be considered under that provisional agenda is accounting for SMEs, which was originally requested at the fifteenth session of the Intergovernmental Working Group and approved by the third session of the Commission. It was also suggested that environmental performance indicators, corporate governance and corporate social responsibility be included as possible topics for discussion at the seventeenth session of the Group.

6. The Intergovernmental Group of Experts (IGE) on Competition Law and Policy was convened from 7 to 9 June 1999. The meeting discussed: (a) the relationship between competition authorities and relevant regulatory agencies, especially in respect of privatization and demonopolization processes; (b) international merger control, in particular where mergers and acquisitions have effects in developing countries; and (c) the creation of a culture of competition. The IGE also reviewed UNCTAD's technical assistance activities

in developing countries and economies in transition in the course of 1998, and, acting as a preparatory meeting for the fourth review conference, agreed on a provisional agenda for the conference, to be held in September 2000. It also considered a preliminary assessment of the experience gained so far with the implementation of the Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices. The deliberations and conclusions of the IGE will be reported to the fourth session of the Commission under agenda item 5 and are contained in document TD/B/COM.2/19.

7. The Commission also recommended that the secretariat continue its technical assistance activities geared towards capacity-building in developing countries in policies related to the area of private capital flows. In addition, the Commission requested a continuation of UNCTAD's work programme on a possible multilateral framework on investment, and in particular work on the series of technical papers on issues in international investment agreements. As regards the latter, it should be noted that, by August 1999, eight IIA issues papers had been published and that another four had reached pre-publication stage, with an estimated total of 16 papers published before the end of 1999. It should also be noted that by October 1999, a total of 113 countries will have benefited from this work programme through the regional symposia and "Geneva" seminars organized by the secretariat (see annex). As regards other technical assistance activities, the background note on "DITE's Activities 1998-1999" (UNCTAD/ITE/Misc.16) provides a detailed account of the activities implemented by the secretariat in the areas of investment, technology and enterprise development since the third session of the Commission.

8. Finally, it should be noted that in pursuance of these activities, the Secretariat has cooperated closely with other international organizations, especially WTO, the World Bank Group, ILO, UNIDO and other United Nations specialized agencies. It has also benefited from cooperation with regional and non-governmental organizations such as OECD, ASEAN, SELA and SADC, in the case of the former, and WWF, SOMO, OXFAM, Friedrich Ebert Foundation and Quaker United Nations Office, in the case of the latter. Lastly, it is noteworthy that the Secretariat's work on investment, technology and enterprise development has greatly benefited from cooperation with the private sector.

Annex

Implementation of the work programme on a possible multilateral framework on investment: Participation in regional symposia and Geneva seminars

Regional symposia *(co-organizing institution in italics)*	**Participants**
Fez, Morocco, 19-20 June 1997	Algeria, Angola, Burundi, Cameroon, Egypt, Ethiopia, Gabon, Kenya, Lesotho, Malawi, Mauritania, Morocco, Mauritius, Namibia, Nigeria, South Africa, Swaziland, Tunisia, Uganda, Zambia, Zimbabwe (21)
New Delhi, India, 15-16 July 1998	Azerbaijan, Bangladesh, Democratic People's Republic of Korea, India, Indonesia, Malaysia, Maldives, Mongolia, Nepal, Pakistan, Philippines, Republic of Korea, Singapore, Sri Lanka, Thailand, Viet Nam (16)
Kingston, Jamaica, 27-28 September 1998 *Organization of American States and the University of the West Indies*	Antigua and Barbuda, Bahamas, Barbados, Grenada, Guyana, Jamaica, St. Kitts, St. Lucia, St. Vincent and the Grenadines, Trinidad and Tobago, Venezuela (11)
Lima, Peru, 4-6 November 1998 *General Secretariat of the Andean Community and Organization of American States*	Bolivia, Columbia, Ecuador, Peru, Venezuela (5)
Cairo, Egypt, 17-18 May 1999 *Inter-Arab Investment Guarantee Corporation and League of Arab Nations*	Algeria, Djibouti, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libyan Arab Jamahiriya, Mauritania, Morocco, Oman, Palestine, Qatar, Saudi Arabia, Somalia, Sudan, Syrian Arab Republic, Tunisia, United Arab Emirates, Yemen (20)
Regional symposium for the least developed countries, Geneva, 29 September-1 October 1999*	(Provisional list of participants not yet available.)
Xiamen, China, 9-10 September 1999* *United Nations Development Programme*	Algeria, Argentina, Bangladesh, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ethiopia, Gabon, Ghana, India, Indonesia, Jamaica, Jordan, Malaysia, Mexico, Morocco, Philippines, Republic of Korea, Saudi Arabia, Senegal, South Africa, United Republic of Tanzania, Thailand, Tunisia, Viet Nam, Zimbabwe (28)

"Geneva" seminars *(co-organizing institution in italics)*	**Participants**
Glion-sur-Montreux, 26-27 February 1998 *World Trade Organization*	Australia, Barbados, Brazil, China, Estonia, Ethiopia, European Union, Hong Kong SAZ China, Hungary, Japan, Republic of Korea, Malaysia, Mexico, Morocco, Netherlands, Norway, Panama, Philippines, Russian Federation, Switzerland, Thailand, Turkey, Uganda, United States of America, Venezuela, Zambia (26)
Glion-sur-Montreux, 8-9 June 1998 *World Trade Organization*	Bahrain, Bangladesh, Canada, China, Croatia, Cuba, Dominican Republic, Egypt, El Salvador, Estonia, France, Honduras, Indonesia, Mauritius, Mexico, Pakistan, Panama, Philippines, Singapore, Spain, Suriname, Venezuela, Uganda, Zimbabwe (24)
Evian-les-Bains, 21-22 April 1999 *World Trade Organization and Organisation Internationale de la Francophonie*	Austria, Bangladesh, Benin, Burkina Faso, Cameroon, Cape Verde, China, Côte d'Ivoire, Croatia, Cuba, Egypt, France, Gabon, Guatemala, Guinea, Iran, Jamaica, Kyrgyzstan, Madagascar, Malaysia, Mauritius, Nicaragua, Niger, Republic of Korea, Rwanda, Saudi Arabia, Senegal, Slovakia, Sri Lanka, Thailand, Uzbekistan, Viet Nam (32)

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INVESTMENT POLICY AND SCIENCE, TECHNOLOGY AND INNOVATION POLICY REVIEWS: METHODOLOGY AND EXPERIENCES

Note by the UNCTAD secretariat

Executive summary

This note contains a brief overview of the national policy reviews carried out by the UNCTAD secretariat. It introduces the investment policy reviews undertaken in Egypt, Peru, Uganda and Uzbekistan, and the science, technology and innovation policy reviews undertaken for Colombia and Jamaica. This note complements the individual country reviews by drawing common policy implications with respect to such issues as determinants of foreign direct investment, privatization, policy coherence, economic linkages, inter-firm collaboration, infrastructure and support institutions.

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Introduction

1. UNCTAD undertakes investment policy reviews with member States that so desire in order to familiarize other Governments and the international private sector with an individual country's investment environment and policies, (in accordance with paragraph 89(c) of "A Partnership for Growth and Development"). Reviews have been carried out for Egypt, Uganda and Uzbekistan, and are under way for Ecuador and Peru. The next round of investment reviews includes Kenya, Mauritius, Pakistan and Zimbabwe. The reviews have benefited from the financial support of the United Nations Development Programme (UNDP) and the Government of Switzerland.

2. UNCTAD undertakes science, technology and innovation policy (STIP) reviews with interested countries in order to identify options for national action, especially those which foster technological capability and innovation and the transfer of and diffusion of technology, (in accordance with paragraph 89(k) of "A Partnership for Growth and Development" and resolution 1995/4 of the Economic and Social Council). STIP reviews have been carried out in Colombia and Jamaica, and are under way in Ethiopia and the United Republic of Tanzania. Requests for similar reviews have been received from Belarus, Cuba, Lithuania, Myanmar, Romania and Venezuela. The STIP reviews have benefited from the financial support of UNDP and the Governments of Italy and the Netherlands.

3. In order to facilitate consideration of the individual country reviews, and their methodology and experiences, the present note provides a brief overview of the work completed and in progress. Some of the more general policy implications arising from the completed investment and STIP reviews are also outlined.

I. Investment policy reviews

A. Methodology

4. The investment policy reviews assess a country's investment environment and policies. In particular, the reviews examine the country's objectives and competitive position in attracting foreign direct investment (FDI), evaluate the country's FDI policy and institutional framework, and delineate its policy options. Details on the evaluation methodology are provided in the annex. The reviews go beyond an examination of how FDI policies look on paper, and investigate how successful those policies are in practice in achieving stated national objectives. Since investor response is based on both policy and non-policy factors, a key feature of the reviews is to survey both actual and potential investors to find out how they perceive current investment conditions and opportunities in the target country. Based on an analysis of investor perceptions and also of the relevant FDI trends at the regional and global level, the reviews assess the country's core competencies in attracting FDI, and then gauge the effectiveness of policies in leveraging the competitive strengths of a country and in remedying potential weaknesses. Although the reviews have a country focus, they proceed in a global context, comparing the country's policies, strengths and weaknesses with those of other countries, particularly in the same region. The reviews are underpinned by the data and analysis contained in UNCTAD's *World Investment Report*.

5. The investment policy reviews are carried out by UNCTAD staff and by external and national experts, and they involve public and non-governmental institutions, including the private sector. The reviews are presented and discussed in national

workshops involving public officials and other interested groups. The final reports are widely disseminated.

B. Experience

6. **Egypt.** The investment review of Egypt was initiated in July 1997 and completed in March 1999. A number of national experts prepared background papers. A survey of 88 foreign companies operating in Egypt was carried out. Two national workshops were held, one in Cairo, sponsored by the Egyptian Federation of Industries, and the other in Alexandria, sponsored by the Alexandria Business Association. The participants, numbering over 200, included company executives from ABB, Arab Bank, Microsoft, Nile Clothing and Oriental Weavers. The review notes the efforts being made to improve the policy environment as well as areas where there is room for further improvement. The review also notes that the broad range of reforms to support export-led private sector growth has not yet attracted much export-oriented production, and suggests elements for an FDI strategy.

7. **Uganda.** The investment review of Uganda was initiated in January 1998 and completed in August 1999. The review notes that Uganda has made great strides in improving economic conditions and the investment climate, and has been rewarded with a revival of inward FDI flows, which have been among the highest in Africa. The legal and policy framework for investment is generally sound, but efforts to modernizing the investment code and orient the investment agency towards FDI promotion need to be followed through. Infrastructure and utilities constrain new investment and need improvement. An eight-point plan for investment promotion is proposed, and is to be presented to the Government at a cabinet briefing in September 1999, in parallel with the national workshop on the review.

8. **Peru.** The investment review of Peru was initiated in November 1997, with the commissioning of national experts to prepare a background study and undertake an investor survey. A fact-finding mission was carried out in December 1998 and the report is due to be finalized in September 1999. The review notes that Peru has dramatically improved its investment climate in the 1990s, and that FDI inflows have been high by world standards, enabling Peru to become one of the top 10 host developing countries. The country's investment policy framework compares favourably with that of any country in the world. However, Peru still needs to attract more steady inflows of FDI, to diversify the sources of such investment, and to channel both foreign and domestic savings into new productive investment.

9. **Uzbekistan.** The investment review of Uzbekistan was initiated in November 1997 with a joint fact-finding mission involving staff from UNCTAD and the Organization for Economic Co-operation and Development (OECD), as well as an international expert. The report was issued in April 1999. The review identifies both the innate strengths of the country as an investment destination, and several economic and investment policy weaknesses that appear to have led to investment levels that are well below the country's potential. The review sets out 10 recommendations addressed to the Government of Uzbekistan to improve the investment climate and further boost the country's attractiveness as a destination for FDI. The recommended reforms are aimed at making Uzbekistan the prime foreign investment destination in Central Asia and an example of best practice for other countries in the region.

II. Science, Technology and Innovation Policy reviews

A. Methodology

10. The STIP reviews assess the effectiveness of a country's science and technology (S&T) policies in supporting innovative activity in the enterprise sector. Traditionally, S&T policies and institutions (e.g. national laboratories, university research institutes and technical standards bodies) have aimed at the generation of new knowledge, but for many developing countries the main priorities are the transfer and diffusion of existing technology, the building of technological capabilities of productive enterprises, and fostering their capacity to innovate and compete in the global economy. Thus, there is often a need to orient S&T policies and institutions towards the needs of the users of innovations. STIP reviews assess how well the country's S&T infrastructure supports innovation and technological change at the enterprise level.

11. The methodological framework of the STIP reviews is the "national system of innovation" (NSI), defined as the network of economic agents whose actions initiate, import, adapt and diffuse new technologies, taken together with the public and private institutions and policies that influence their innovative behaviour and performance. In the NSI perspective, S&T institutions (the suppliers) and productive enterprises (who provide the demand) interact with one another and, through the exchange of information and knowledge, bring new products and processes into economic use. The important players include universities, technological institutions, research and development (R&D) centres, industry associations, financial institutions and, of course, enterprises of all kinds, large and small. The STIP reviews map a country's NSI and assess how the elements of the national policy framework relevant to the NSI can be enhanced to support innovation activities in enterprises.

12. The STIP reviews comprise a background country report prepared by the national counterpart institution and an evaluation report prepared by an international team of experts that includes members of the secretariat. The two reports are discussed at a national round-table meeting, and later issued as a single publication.

B. Experience

13. **Colombia**. The first STIP review was undertaken in Colombia in 1995-1997. Among the recommendations that have been, or are being, implemented are: the restructuring of current financing schemes for existing and additional R&D resources; the transfer and allocation of sufficient resources for R&D and innovation in general; and other public sector initiatives reflected in the refocusing of public expenditures to take into consideration innovation activities and programmes. The national training agency has been restructured to incorporate training for innovation. In addition, national bodies charged with the strengthening of intermediary institutions (e.g. the standards and quality control institute, business support agencies) have been advised on innovation-related S&T policies and on how these can be better integrated into the institutions. The response of both the public and private sectors to this exercise has been positive.

14. **Jamaica**. The second STIP review was undertaken in Jamaica in 1997-1998. A number of recommendations proposed by the review team have been adopted, particularly in the information technology sector. Eight projects, covering the

fields of education, technology and entertainment have been designed and are at the implementation stage. These stem directly from the review. Currently the Jamaican National Commission on Science and Technology is considering and seeking resources pertaining to the recommendations made in the entertainment sector (particularly music) and in the agro-business sector. The Jamaican NSI is being developed and, as proposed by the STIP review, will feature the integration of the country's national institutions. As a follow-up to the review, a subregional project entitled "Becoming a global player: opportunities in the music industry for developing countries" has been initiated. Several other Caribbean countries, including Cuba and Trinidad and Tobago, have shown interest in this project.

15. **Ethiopia.** The third STIP review was initiated in Ethiopia in November 1997. The Ethiopian Investment Authority and the Ethiopian Science and Technology Commission have jointly prepared the country background report. An evaluation mission consisting of UNCTAD officials and three international experts was carried out in November 1998. The mission focused on five areas identified by the Government as priorities: the small and medium-sized enterprise sector, investment, policy coordination, agriculture and the leather industry. The evaluation report is scheduled for completion in August 1999. The final round-table meeting presenting the conclusions and recommendations of the review to the Government is scheduled for September 1999.

III. Policy implications

16. In all the developing countries reviewed, inward FDI has been registering an upward trend. FDI has also been contributing to capital formation in countries where domestic savings are low, (such as Uganda). However, FDI should be seen as complementary to domestic efforts. High national savings and investment rates, as well as technological capabilities, tend to attract greater FDI inflows. The main national objective in seeking FDI is the package of benefits that can accompany foreign capital, including technology, managerial know-how and privileged access to world markets.

17. **FDI determinants.** A key factor contributing to greater FDI inflows is the macroeconomic and policy environment. Almost all the countries reviewed are characterized by political stability, encouraging macroeconomic indicators and transparent, investor-friendly policy regimes. In the UNCTAD country surveys, investors cited a friendly regulatory environment, liberalized rules for FDI and a growing economy as important factors in selecting an investment location. However, a country's competitiveness is also determined by the microeconomic environment in which firms operate. In this respect, most of the countries reviewed have been generally less successful in creating a conducive environment for business operations. The obstacles include factors such as bureaucratic procedures and regulatory frameworks, infrastructural bottlenecks, a shortage of technically trained personnel and the relative absence of support institutions.

18. **Privatization.** FDI is attracted by privatization opportunities. While privatization is expected to lead to increased efficiency and productivity, it may not always add new capacities, at least in the short term (as in Uganda). FDI inflows into privatized sectors appear greater where there are, from the outset, transparent rules backed by effective implementation. Best practice in Peru includes the strategic design of transactions (e.g. in utilities) to appeal more to industrial investors rather than to financial investors, transactions executed by investment banks and the development of concessions or "build-operate-transfer"

contracts after the privatization programme, thus facilitating the private management of infrastructure projects in certain utilities. The present modest levels of FDI in Uzbekistan are due to the country's deliberate choice of a transition policy of economic reform that has so far precluded privatization of the utilities and major State enterprises.

19. **Policy coherence.** The investment environment can be improved by ensuring greater policy coherence and implementing government policies more effectively. In Uzbekistan, for example, the individual policies of Government agencies either fail to support the Government's objectives or in some cases actually work against these objectives. Similar tendencies are also observed in Ethiopia, where the investment regime is relatively more open than the technology regime with respect to technology transfer. Incoherent policies give conflicting signals to potential investors, and therefore synchronization of complementary policies through inter-agency collaboration at the stages of policy formulation and implementation is vital.

20. **Infrastructure.** The hidden costs arising from weak infrastructures can offset the advantages of low labour costs (as in Uganda). Poor road networks raise transport costs and increase delivery time. An irregular supply of electricity means that manufacturing operations cannot operate at full capacity. Building an efficient infrastructure is mainly the domain of public investment and development assistance, although there are opportunities for private sector participation in some areas.

21. **Linkages.** In most countries, FDI has not created strong linkages in the local economy. The value added by foreign firms tends to be the labour component, as many inputs and components are imported. A chain-of-production approach has been used successfully in Colombia to encourage the formation of backward and forward linkages. In order to address technological problems faced by enterprises participating in particular productive value-added chains (e.g. textiles-clothing, steel-mechanics, wood-pulp, paper-printing), specific incentive mechanisms were developed to stimulate enterprises to develop high-tech products designed and produced locally. This approach, when combined with a strategy based on attracting FDI into targeted sectors of comparative advantage, where raw materials and other inputs are available in the country, could help to create clusters of industries, in which suppliers, customers, subcontractors and support institutions are present. As a result of such a strategy, FDI can help to create stronger linkages within an economy.

22. **Support institutions.** Technology and business support services can help firms shift from low value added activities to high value-added activities. In many countries, S&T support institutions exist, but operate in isolation from one another, and with few linkages to the productive sector (see the STIP reviews for Colombia and Jamaica)[1]. Bringing S&T closer to the needs of local production and building a nexus between formal centres of knowledge generation and production remains a serious challenge. One policy priority could be to urge public research institutes to collaborate with the private sector and to encourage enterprises to invest in R&D, if not for the generation of new technologies then for the adaptation of imported technologies and their effective utilization. Public training institutions may require reorientation in line with the needs of production. Support can also be provided through the creation of venture and risk capital funds. Such funds, especially those aimed at small and medium-sized enterprises, are common in

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[1] UNCTAD/ITE/IIP/5 and UNCTAD/ITE/IIP/6

the industrialized world. Generally, there is an inadequate demand for technology services by the enterprise sector.

23. **Inter-firm collaboration.** Policies should be designed to promote inter-firm collaboration, in terms of sharing and pooling knowledge and resources. Interaction between firms creates synergies and beneficial externalities, and fosters the development of dynamic clusters of industries (as in the case of the coffee and cut-flower clusters in Colombia). The field survey conducted in Ethiopia shows that firms that have links with other firms undertake technical change faster than firms operating independently. On the other hand, firms that fail to learn or to engage in innovative activities are either those that operate in a less competitive environment or those that do not face pressure to change. Thus, horizontal and vertical knowledge flows between firms, clients and suppliers are important. One implication for policy is that partnerships and cooperation between foreign firms and domestic enterprises can promote learning in local companies.

Annex

Evaluation methodology of the investment policy reviews

1. The investment policy review evaluates a country's FDI regime both in terms of the declared national objectives and, on a comparative basis, in relation to international best practice. The evaluation considers the content of policy instruments, the administrative procedures through which policies are implemented and actual practice as experienced by investors. This analysis is undertaken on the basis of questionnaires sent to the Government and to firms with operations in the country, supplemented by other sources. The following areas are examined:

(a) Policy and operational framework for FDI:

(i) The main regulatory conditions for foreign investors: entry and establishment; ownership and control requirements; sectoral restrictions; authorization and reporting; operational conditions (including performance requirements, licences, personnel requirements); and standards of treatment;

(ii) The main protections for foreign investors: national and most-favoured-nation treatment; fair and equitable treatment; legal protection and guarantees (including general standards and specific standards on, e.g., expropriation); transfer of funds and repatriation of profits and capital invested (including exchange controls and currency convertibility); access to international means for settlement of investment disputes; and standards for foreign investors provided by international instruments (bilateral, regional, interregional, multilateral);

(iii) Additional standards that govern foreign investors: competition policy (including restrictive business practices); monopoly regime; public sector privatization; merger and acquisitions regime; market preferences; accounting and reporting; consumer protection; environmental protection; and quality and safety standards;

(iv) Any special regulatory conditions for non-equity arrangements, such as management contracts, licensing and franchising and "build-operate-transfer" schemes;

(v) Any special provisions for specific sectors and industries, particularly those of present or future importance for FDI;

(vi) The structure of fiscal and financial incentive measures and preferential market treatment offered at all levels of government, including discretionary or ad hoc incentives;

(vii) Other promotional measures, such as: investor services (e.g. information, "one-stop shops", post-investment services); investor facilities (e.g. infrastructure, export processing zones, science parks); and home country measures (bilateral tax treaties, trade preferences, development aid);

(b) Administrative procedures and practices:

(i) The institutional framework for FDI and its modus operandi, including issues such as: degree of centralization of the bureaucracy; the degree of discretion given in the interpretation and implementation of policies; the level of complexity or simplification of administrative operations; the extent to which implementation is monitored; and the costs and benefits of promotional programmes;

(ii) Transaction costs and the efficiency of administrative procedures as perceived by business, in terms of practical issues such as delays in obtaining approvals. This includes areas such as the judicial system (e.g. the predictability of business contracts), the fiscal regime for business activities and the banking and financial system and security markets.

2. **Policy coherence**. Given the interlinkages between investment, trade, the transfer and diffusion of technology and financial transactions, it is important that policies in these various spheres point in the same direction in a coherent and complementary fashion.